

Understanding trusts

Navigating the role of the beneficiary

You've become a beneficiary of a trust. On one hand, that sounds great; on the other, it may feel overwhelming. You probably have a vague idea of what a trust is and perhaps have some idea of what it's supposed to accomplish. But trusts can be exceedingly complex. If you've seen a copy of the trust agreement, you're probably even more confused. A lot of that confusion and intimidation can be overcome if you're able to gain a sense of empowerment. This paper is designed to be the first step in that journey.

One way to approach the task of understanding trusts is to view them as a complex "language game": If you can master the vocabulary, you'll understand the trust. To help learn the language, we encourage beneficiaries to take the initiative by asking lots of questions and doing research. Performing even a little bit of this work will help you feel less intimidated and will help you address or preempt potential confusion.

As a starting place, we'll provide a few principles and guidelines, and a glossary of common terms, to help you expand your understanding and to empower you as a beneficiary. There will still be lots to learn, but we'll attempt to convey the basics.

For a valid trust to exist, it must have a grantor, a trustee, and a beneficiary, and it must hold some assets. It can help to understand the various roles of the people or institutions involved in managing those assets:

Grantor	Someone who creates and funds the trust. Also sometimes called "trustor," "settlor" or "donor."
Trustee	The person or institution that manages assets owned by a trust under the terms of the trust agreement. A trustee's purpose is to manage trust assets, maintain the books and records of the trust, and distribute trust income and/or principal as directed in the trust agreement.
Trust protector	A person many modern trusts designate with the power to remove and replace the trustee. This individual may also have the power to modify certain provisions to keep current with changing laws.
Beneficiary	A person or organization legally entitled to receive benefits from the trust assets.

In many cases, one person can have multiple roles (for example, someone might be the grantor, trustee and beneficiary or just the grantor and beneficiary, but not the trustee). One way to think about this is to ask which "hat" a person is wearing when operating in different roles. The reasons for this are complex but have to do with both the objectives of the grantor and the specific legal requirements to meet those objectives, which are often driven by tax considerations or a desire to protect assets from creditors.

While trusts can get very complex, the following four principles are a good starting point for understanding any trust.

Principle 1: The beneficiary typically benefits from distributions of income and/or principal

Trust assets might be invested to produce income that can be distributed to the beneficiary. If a beneficiary has a right to all of the trust's income, it's typically distributed on a regular periodic schedule, which may be monthly, quarterly, semi-annually or annually. Or, the beneficiary might be entitled to outright distributions of trust assets, which is sometimes tied to the beneficiary reaching a specific age or some life event, but often at the sole discretion of the trustee.

Distributions to beneficiaries are sometimes direct (the beneficiary receives the income or assets, such as a cash payment, home or vehicle) or indirect (the trust pays a third party for the benefit of the beneficiary, for example, tuition payments being made directly to a university). Understanding how these distributions are set up — what can and cannot be distributed,

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when distributions can be made, any distribution conditions and the like — is important for a beneficiary to understand.

Principle 2: The trust will have a purpose

The overarching purpose is to benefit the beneficiary. Three of the most common ways trusts provide these benefits are through tax reduction, asset protection and/or wealth preservation. Not every trust will have all of these purposes, and some will be focused on only one of the three:

- **Tax reduction.** Trusts can be a powerful tool, enabling a person to pass assets to heirs and future generations at an optimal tax cost.
- **Asset protection.** When legal ownership is properly separated from beneficial ownership (see Principle 3), creditors of a beneficiary often can't touch the assets in trust.
- **Wealth preservation.** Trusts are often established to preserve a large estate from depletion brought on by overspending heirs.

Principle 3: All trusts share a basic structure designed to separate legal and beneficial ownership

Trusts fundamentally separate the **ownership** of assets from the **control** of assets. Legal ownership, vested in the trustee, allows the trustee to make all decisions about possession, sale, purchase, investment and distribution of trust assets. The unique powers of the trustee, as legal owner, are spelled out in the trust agreement. Beneficial ownership is the right to enjoy the benefits of the property held in the trust. The extent of these benefits is also spelled out in the trust agreement.

For example, imagine you owned a house outright. You could make all the decisions about improving or selling it **and** enjoy living in it — you'd be both the legal owner (control the asset) and the beneficial owner (enjoy the asset). If a trust owned the house, only the trustee could make decisions about things like remodeling and selling it. Anything related to the control of the asset would be the trustee's responsibility. You'd still be able to live in the house and enjoy it, but you couldn't make any significant control decisions on your own.

This split between legal and beneficial ownership may confer advantages in terms of tax reduction and asset protection. But it also brings some significant challenges, such as potential frustration for the beneficiary over the lack of control and the added complexity of managing the asset via the trust structures.

Principle 4: The trustee has several duties owed to the beneficiary

The trustee has specific legal obligations to the beneficiaries. This is known as a **fiduciary** duty. It includes:

- A duty of loyalty (to put the interests of the beneficiary first)
- A duty of care (to invest the assets prudently)
- A duty of skill (to administer the trust appropriately)
- A duty to disclose (to account for the assets and the administration of the trust)

The specifics of how these duties are to be carried out can be changed and shaped by the trust agreement, but all trustees have these fiduciary obligations in one form or another. Without a trust protector granted the power to do so, the only way to enforce the terms of the trust is by filing a lawsuit.

With these principles in mind, we encourage beneficiaries to follow these guidelines:

1. **Learn how your trust works.** A good rule of thumb is to learn enough about it that you could easily explain it to a reasonably intelligent eighth grader. If you can do that, then you clearly understand the trust.
2. **Understand the role of the trustee(s) and build a good working relationship with them.** Ask the trustee to teach you about the trust and work closely with the person to understand what is and isn't possible under the terms of your trust. You can then settle on a distribution plan that takes into account the purpose and duration of the trust, the resources of the trust, and your needs and current resources.

Many long-term trusts have a trust protector, who may have a responsibility to oversee the work of the trustee and even the ability to replace the trustee with a new trustee. If your trust has a trust protector, get to know that person as well. Help him or her understand your needs. A trust typically creates long-term relationships, and ensuring solid professional communication among everyone involved is likely to make the beneficiary experience as positive as possible. Understanding and respecting the job the trustee has to do will go a long way toward building an environment that will serve you well in the long run.
3. **Understand how your trust assets are invested.** Monitor the performance of your trust. While you might not have the power to invest, you'll likely have an influence on what the trustee does and doesn't do with trust assets. You should understand how the trustee views long- versus short-term investing. You'll also want to follow the way trust assets are reported and tracked. Ask your Merrill advisor to help you understand the reports that your trustee sends you. When you meet with the trustee, ask questions about how the funds are being invested. Many trusts have an investment policy statement, and, if it exists, you should obtain a copy of it.

4. **Follow the process.** Unless the trust allows for unlimited discretionary distributions to you, you'll usually have to make an application to the trustee for an irregular distribution. In that case, you'll have to use the distribution for a purpose authorized by the trust, and you'll most likely have to provide documentation to the trustee that will support the request. The trustee will make a decision to give you something other than what the trust requires based on the purpose of the trust, the rights of other current or future beneficiaries, and whether the trustee believes that the purpose of the distribution fits generally within the trust guidelines.

For example, if the trust was set up for multiple generations, and one person is asking for distributions that would deplete the trust, the trustee might deny the request.

5. **Speak up.** If you need something from the trust or feel that you're not being kept informed about the administration of your trust, you should let your trustee know and seek the answers that will be helpful to you. The trustee is intended to look out for your best long-term interest and well-being, and to keep you informed about the administration of the trust.

Glossary of terms

Assets. Property held in the trust (otherwise known as "principal" or "corpus").

Beneficiary. A person or organization legally entitled to receive benefits through a legal device, such as a will, trust or life insurance policy.

Bequest. A specific gift of personal property to an individual at death.

Decedent. A person who has died.

Devise. A specific gift of real estate at death.

Discretionary distribution. An irregular distribution from a trust that the trustee makes in accordance with the terms of the trust agreement (see "Mandatory distribution").

Estate tax. A tax levied at death based on the value of the deceased person's assets at the time of death.

Executor. A person named in a will and appointed by the court to carry out the terms of the will and to administer the decedent's estate. May also be called a "personal representative." While a will might create trusts, these trusts are different entities designed to manage any assets not already in trust upon the death of the person who wrote the will.

Exemption. An amount set by law that's not taxed.

Fiduciary. A term, derived from Roman law, that applies to a person or entity that has accepted a responsibility that must be performed in the best interests of another person or entity. In other words, actions cannot be based on self-interest; the interest of another must come first. Executors and trustees are fiduciaries.

Generation-skipping transfer tax. A tax imposed when assets skip at least one generation within a family (for example, grandparents leave assets to grandchildren, thereby "skipping" their own children). Also applies to non-family relationships when the recipient is greater than 37.5 years younger than the giver of a gift.

Generation-skipping trust. A trust that skips a generation (established for tax purposes).

Grantor. Someone who creates a trust. Also called a "trustor," "settlor" or "donor."

HEMS standard. An ascertainable standard that allows for discretionary distributions for health, education, maintenance and support. The application of this standard is determined by the trustee. Matters of health and education are typically not controversial. What's required for support and maintenance are often sticking points in the trustee-beneficiary relationship. The trustee is the immediate arbiter of what's reasonable.

Income. Additional assets, usually monetary, that are earned by an estate or trust by its principal. Common sources of income include interest, dividends, and the net gain or loss from the operation or sale of a business or real property; generally doesn't include capital gains.

Income beneficiaries. Individuals or entities entitled or eligible to receive trust income; usually current beneficiaries.

Inter vivos trust. A trust that's created during the grantor's lifetime.

Irrevocable. The trust cannot be unilaterally changed by the grantor after signing.

Issue. Direct descendants, whether by birth or, in some cases, adoption.

Mandatory distribution. A distribution that must be made by a triggering event, such as someone reaching a certain age.

Per stirpes. A Latin term meaning "per branch." It's a method for distributing property according to the family tree whereby descendants take the share their deceased ancestor would have taken if the ancestor were living. Each branch of the named person's family is to receive an equal share of the estate. If all children are living, each child would receive a share, but if a child isn't living, that child's share would be divided equally among the deceased child's children.

Power of appointment. The right of the current beneficiary to redirect the disposition of assets from the default distribution. The trust may be structured so the beneficiary can exercise this right during life or at death (testamentary).

Principal. The property (such as money, stock and real estate) contributed to or otherwise acquired by a trust to generate income and to be used for the benefit of trust beneficiaries according to the trust's terms. Also referred to as "trust corpus."

Probate. A court proceeding to distribute assets left under a will (but not a trust).

Remainder. The assets remaining after specific gifts have been made to individuals.

Remainder beneficiaries. Individuals or entities entitled to receive the trust property remaining at the end of the trust's term, after the current/income beneficiary passes away or after a triggering event. A remainder beneficiary is sometimes referred to as a "remainderman."

Restatement. The complete revocation and amendment of all the language of a trust agreement. This allows the trust to continue with the same name but under new terms and provisions.

Revocable. The trust can be amended and changed at will.

Situs. The state that has primary jurisdiction over the trust.

Spendthrift clause. A trust provision restricting both voluntary and involuntary transfers of a beneficiary's interest in a trust by the beneficiary, frequently in order to protect assets from

claims of the beneficiary's creditors; sometimes used to curb overspending and unnecessary invasions of principal.

Split-interest trust. Divides interests in assets among different people or entities; for example, a trust that distributes trust income to a charity for 15 years but then distributes whatever principal remains to the grantor's children.

Testamentary trust. A trust established under a person's will to come into operation after the will has been probated and the assets have been distributed to it in accordance with the terms of the will.

Trust. A legal arrangement whereby property is legally owned and managed by an individual or corporate fiduciary as trustee for the benefit of another, called a beneficiary, who's the equitable owner of the property.

Trust principal. The assets held in the trust; sometimes called the "corpus."

Trust protector. A person who has the power to update administrative provisions relating to the trust as laws evolve, which may include the ability to remove and replace a trustee.

Trustee. The person who manages assets owned by a trust under the terms of the trust agreement between the grantor and the trustee. A trustee's purpose is to safeguard the trust and distribute trust income and/or principal as directed in the trust agreement. In a revocable living trust, the grantor is generally also the trustee. Trustees can be paid or unpaid.

Sources

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